

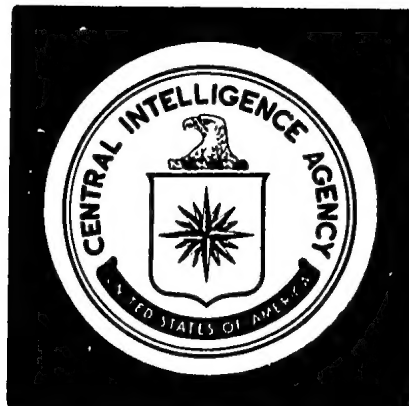
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CIA-RDP85T00875R00170003

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ER IM 72-14

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**DIRECTORATE OF
INTELLIGENCE**

Intelligence Memorandum

Chile's Foreign Exchange Crunch

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ER IM 72-14
January 1972

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**CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
January 1972**

INTELLIGENCE MEMORANDUM

CHILE'S FOREIGN EXCHANGE CRUNCH

Summary

1. President Salvador Allende is facing his first major economic crisis since taking office in November 1970. Net foreign reserves, which stood at a record \$378 million when he was elected, plummeted by the end of 1971 to \$45 million – about two weeks' imports at current levels. The Allende administration has further tightened exchange controls and assumed a virtual monopoly over export and import transactions. In November, Allende called for a renegotiation of Chile's large foreign debt, which totals some \$2.3 billion (including about \$1.4 billion to the United States), and stopped payments to most foreign creditors.

2. Chile's foreign exchange crunch derives both from a shortfall in export receipts and from inflated imports. Lower world prices and production difficulties after government takeover of the copper mines brought a 20% drop in copper export earnings in 1971. At the same time, import requirements rose as a result of government income redistribution policies that produced a consumer spending spree. Although consumer goods production was raised by bringing into use idle capacity, this source of additional supplies has become exhausted, and industrial goods imports have increased. An even greater increase has occurred in food imports, as land reform policies have disrupted food output. The worsening political and economic atmosphere produced a reversal in capital flows from a large net surplus to a \$100 million deficit, despite the cutoff in US copper company remittances abroad. By late 1971, shortages of food and manufactured goods were increasingly apparent even though government import policy was aimed primarily at filling politically embarrassing gaps between supply and demand.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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3. Chile will continue to face serious balance-of-payments difficulties in the next year or so, even if it succeeds in obtaining substantial debt relief in upcoming negotiations with its creditors. In 1972, imports almost certainly will not be significantly above last year's inadequate level, and they may be cut significantly. Stagnant or reduced import capacity will force Allende to choose between placating the Chilean consumer and making badly needed investments in the economy. He cannot do both, and shortfalls of either type will carry political costs.

Background

4. Chile's traditionally weak balance-of-payments performance improved greatly during the Frei administration. Copper sales, some 70%-80% of export earnings, more than doubled between 1964 and 1970. Although imports and profit remittances increased even faster than exports, the current account deficit was more than covered by large capital inflows. US loans and grants averaged more than \$100 million a year during 1965-70, and a copper industry expansion program brought in an additional \$447 million during the period.

5. The large capital inflows of the Frei period were accompanied by a rapid increase in external debt, which soared from less than \$1 billion in 1964 to some \$2.3 billion in 1970. This jump was predominantly the result of new borrowing, but the government's purchase of controlling interests in the principal copper mines in 1967 and 1969 was also a factor. The Frei administration expected that rising export earnings resulting from the copper expansion program would allow Chile to cope with the increased debt service burden.

Ingredients of the Foreign Exchange Crisis**Copper Situation**

6. With Allende's election it was a foregone conclusion that the US share of Chile's copper industry would be nationalized, and there were doubts that adequate compensation would be paid. Allende promised compensation, however, and a tedious verification of the companies' assets and liabilities was undertaken. Nevertheless, on 11 October 1971 the comptroller general announced that the two largest US companies not only would receive no compensation but in fact owed some \$378 million, which, because of constitutional limitations, the state would not try to collect. By Chilean calculations, the companies had taken \$744 million in excess profits during 1955-70. Because the alleged excess profits exceed the total government-assessed value of the properties, Santiago currently is even refusing to make payments on that part of the mines purchased by the Frei government.

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7. Chile took over the copper mines at an ideal time from the point of view of capital flows. Gross investment inflows under the copper expansion program -- then nearly completed -- were scheduled to decline from an average of \$150 million annually during 1968-70 to less than \$20 million in 1971. At the same time, the outflow in profit remittances, depreciation, and copper debt payments were scheduled to increase from \$135 million to \$255 million.* Nationalization automatically cut off all copper profit remittances, and the decision not to pay compensation and to suspend payments on the equity share purchased by Frei further reduced capital outflows.

8. The copper nationalization, however, came at a difficult time from the technical point of view. At the time of the takeover, new facilities were starting up and technical difficulties were at their greatest. Early last year, when the mines were still under company management, production shortfalls were becoming evident, and these worsened considerably in subsequent months under government control. In 1971, production increased by only 4% -- a sharp contrast with a prediction by the State Copper Corporation (CODELCO) of a 16.6% rise and with the companies' original 26% goal. Even the 4% gain was possible only because two new mines came into production. Output at the two largest mines, Chuquibambilla and El Teniente, decreased by 7.5%. The Chilean government now predicts that production levels planned for 1973 will not be reached until 1975-76. Although CODELCO blames the production shortfalls on the companies' mistakes in design -- and this assessment may be partly justified -- most of the shortfall apparently is the result of government mismanagement, the exodus of many trained technicians, and a drop in labor discipline and morale. The companies probably could have eliminated the technical problems and reached planned output within one year; it is possible that the Chilean government, even with substantial Soviet aid, will not be able to reach this goal at all.

9. The decline in average world copper prices -- from 64¢ per pound in 1970 to about 50¢ per pound in 1971 -- has also hurt Chile's foreign exchange position. Had prices remained the same, earnings -- even with the production shortfall -- would have amounted to about \$900 million in 1971. Because of the price decline, copper earnings probably were no more than \$720 million.

Rising Import Requirements

10. Certain import requirements have increased substantially as a direct result of government policies, and total imports increased 10% in

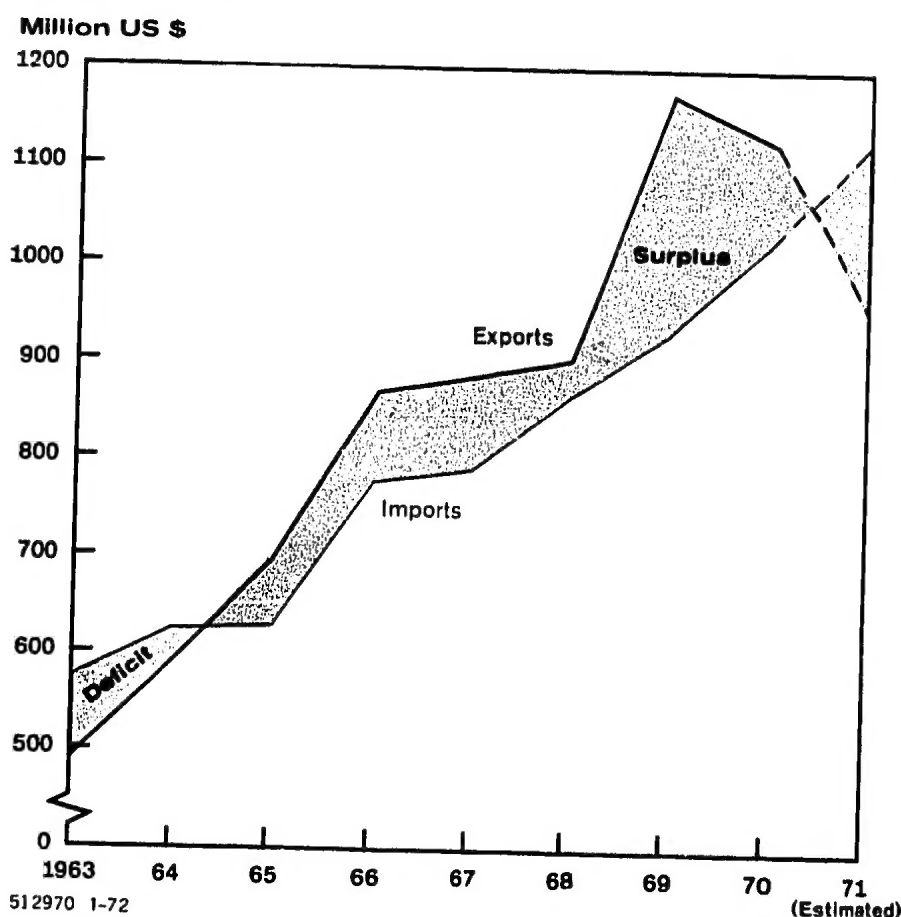
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1971. After taking office, Allende acted quickly to redeem political promises by freezing prices and by raising wages an average of about 45%. The resulting increase in real wages led to a sharp rise in manufacturing output, as excess capacity was put to use. However, because of the government's antagonistic stand on private enterprise - manifested in the widespread seizure of both domestic and foreign firms - little or no new capacity was being generated. Moreover, agricultural production was inhibited by the government's accelerated efforts at agrarian reform and illegal land seizures by peasants. Shortages of both food and manufactured goods soon began to appear, and the government's only remedy was to increase imports at a time when exports were falling sharply.

Chile: Trade Balance



11. These pressures caused a marked change in import composition (see Table 1). Imports of food and beverages rose by more than 57% in 1971, and their share of total imports jumped from 17% to 24%. In contrast, machinery and accessories fell from 26% to 19% of the total, partly because of the near-cessation of foreign copper investment. Imports of durable

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Table 1

Chile: Import Composition

	Million US \$		
	<u>1969</u>	<u>1970 a/</u>	<u>1971 b/</u>
Food and beverages	<u>150</u>	<u>173</u>	<u>271</u>
Unfinished products	105	106	144
For household consumption	33	29	28
For industrial consumption	72	77	116
Finished products	44	67	127
For household consumption	29	40	88
For industrial consumption	16	17	39
Raw industrial materials	<u>233</u>	<u>235</u>	<u>275</u>
Unfinished	24	25	30
Finished	209	210	245
Combustibles and lubricants	<u>56</u>	<u>78</u>	<u>111</u>
Machinery and accessories	<u>269</u>	<u>265</u>	<u>218</u>
Machines	203	203	149
Parts and accessories	66	62	69
Transport equipment	<u>136</u>	<u>105</u>	<u>145</u>
Vehicles	4	2	4
Equipment	83	57	74
Parts and accessories	49	46	67
Consumer goods	<u>73</u>	<u>93</u>	<u>99</u>
Durable	36	52	49
Nondurable	37	41	50
Other	<u>11</u>	<u>72</u>	<u>6</u>
Total	928	1,021	1,125

a. Preliminary.

b. Estimated.

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consumer goods declined moderately because of government restrictions, while those of nondurable consumer goods rose by 22%. By year's end, imports of all categories of consumer goods were rising.

Debt Repayment and Other Capital Flows

12. Chile's net external debt rose from \$2.3 billion in November 1970, when Allende took office, to an estimated \$2.7 billion (about \$300 per capita) by the end of 1971. Scheduled debt servicing payments average about \$373 million annually for the next five years, and the heaviest payments, averaging \$412 million (43% of estimated 1971 export earnings), are due in 1972-74.

13. Outflows of capital have exceeded inflows every month since Allende's election, and in 1971 Chile's capital account registered a deficit for the first time in recent history. Although the lessened inflow is partly a result of the near-completion of the copper expansion program, the worsening economic and political atmosphere is much more important. Immediately after Allende's election victory and before he took office, short-term capital flows, which had been positive during most of 1970, became strongly negative. Direct investment has come to a standstill and new borrowing, whether public or private, has declined sharply.

14. US banks, which still have substantial lines of credit outstanding to Chilean state corporations, are reducing these as rapidly as possible, and no new credit lines are being granted. Allende alleges that Chile already has lost as much as \$190 million in short-term bank credit, but this figure probably is exaggerated. West European and Japanese credit lines, never very important, are now mostly overdrawn, and it is unlikely that they will be increased substantially. As an exception to the general trend, eight Argentine banks recently granted a \$25 million credit line to the Chilean Agricultural Commercial Enterprise to import agricultural products, principally meat, from Argentina.

15. Despite the "wait-and-see" attitude exhibited in most West European countries with regard to extending untied loans and making direct investments, the government-owned Pacific Steel Company has been able to obtain some \$100 million in funds from European consortiums for an expansion program. Although details are lacking, the loan "package" appears to be made up largely of suppliers' credits for the purchase of European equipment. This type of arrangement continues to interest European and Japanese exporters as a means of increasing their share of the Chilean market. US suppliers, on the other hand, show little inclination to provide such credits, and the Export-Import Bank (Eximbank) has stopped financing US exports to Chile.

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16. Despite continued resistance by both Chilean industry and the military to a shift to Communist equipment and technology, Soviet and East European assistance clearly has been growing and seems headed for further expansion. Numerous technical missions have arrived in Chile in recent months to do feasibility studies on a wide variety of projects to be undertaken with Communist aid. Since Foreign Minister Almeyda's mission to Moscow and East European capitals in May-June 1971, long-term credit agreements involving more than \$134 million are known to have been signed, bringing to \$188 million total Communist commitments to Chile. In late 1971, Moscow also provided \$50 million in bank credits which will enable the Chileans to help meet their short-term commercial obligations.

Allende's Reaction to the Crisis**Foreign Exchange and Import Controls**

17. In an effort to reduce the foreign exchange drain, Allende has established a complex system of multiple exchange rates and various currency restrictions. Under Frei, there were two basic exchange rates: the bankers' rate for trade and the brokers' rate for other transactions. Under Allende, there are now four different bankers' rates, ranging from 12.2 escudos to the dollar for exports and for food and petroleum imports to 25 escudos to the dollar for imports of luxury items. Technically, there remains a single brokers' rate, which was recently raised from 14 to 28 escudos to the dollar - a 50% currency devaluation for the transactions affected. In practice, new foreign exchange taxes have created three brokers' rates: a 28 escudo rate for foreign tourists, a 38 escudo rate for payments to foreign creditors, and a 43 escudo rate for Chileans traveling abroad and for payment of foreign royalty and licensing fees. In addition, the amount of foreign currency a Chilean may take out of the country has been further restricted. All foreign currency must be bought and sold through the Central Bank, which is thus able to exercise close control of exchange transactions.

18. The Allende government directly controls imports by private business through a prohibitive (10,000%) prior deposit requirement on about 75% of all imports. The government has stated its intention to extend these controls gradually to most other imports. These restrictions have resulted in a virtual import monopoly for government agencies, which are exempt from the requirement. About 80% of exports also are controlled directly through various state marketing organizations.

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Foreign Debt Default and Renegotiation

19. The seriousness of the foreign exchange crunch was officially recognized on 9 November 1971 when Allende announced that Chile would seek to renegotiate its debt repayment obligations.* Three days later, Santiago suspended debt service payments except for those due on certain short-term obligations to foreign suppliers and banks and \$400,000 of interest due in 1971 on loans from the US Agency for International Development. The suspension was followed by the formal presentation of a memorandum to the US government by the Chilean ambassador in Washington. In this memorandum, Chile requested a three-year (1972-74) moratorium, with deferred payments being distributed over the following ten years.

20. Santiago made a similar presentation to a group of US banks on 14 December, but softened its stand somewhat that same day. The new proposal allowed for "token payments" to the banks during the three-year grace period and reduced the deferred payment period to seven years. In late January the two principal US banks presented a counter-proposal, presently under consideration by the other creditor banks and by Santiago, that provides for a payment of 5% of the principal in 1972 and in 1973, 10% in 1974, 15% in 1975, 10% in June 1976, and 55% in December 1976. If Chile is unable to meet this last "balloon" payment, the proposal permits a substantial extension involving a 10% payment in December 1976 and 15% annually for the next three years. Interest rates during the first five years will be 1-3/4% above the prevailing London Eurodollar rate and 2% above this rate during the additional three years. If agreed upon, the new arrangement would require Chile to pay less than half of the debts due to these banks during the remainder of Allende's presidential term, scheduled to end in November 1976. The banks' proposal probably reflects their belief that a fairly generous compromise is necessary in view of Chile's evident insolvency and is preferable to no payment at all.

21. The United States is the creditor nation that will be most affected by the proposed renegotiation. Of Chile's net external public debt of \$2.3 billion at the end of 1970, some 61% (or \$1.4 billion) was owed to this country, compared with less than 27% owed to all other countries and about 12% owed to international organizations. The other most important creditor nations are Italy, West Germany, France, Spain, United Kingdom, Belgium, and Japan. Should the three-year moratorium be granted, European countries will bear almost as large a burden as the United States. Most of the debt contracted with Europeans consists of short- and medium-term

* This statement was later "clarified" to include only that portion of the debt incurred before Allende came to power.

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suppliers' credits, much of which will fall due during 1972-74. Thus, only 44% of payments that would be affected by the moratorium are scheduled to go to the United States, while 41-1/2% would go to other countries and 14-1/2% to international organizations (see Table 2).

22. Although the Chilean government originally stated that it was not requesting renegotiation of any part of the debt associated with the copper program, debts resulting from US bank loans to the copper companies were included in the renegotiation discussions with New York banks in December. It is possible that Chile also plans to renegotiate loans from the Eximbank and other third-party creditors for the copper program at the meeting in Paris. As was to be expected, Santiago has removed from current consideration any payments on debts owed directly to the US copper companies. Some \$80 million, which Kennecott received from the Frei government for the sale of a 51%-interest in its mine and reloaned to Chile for the expansion program, is not being repaid because it was allegedly "improperly used." Santiago also has refused payment on the \$153 million still outstanding to Anaconda under the Frei purchase agreement, pending review of the case by a Chilean court that normally is responsive to the government's desires.

23. Chile's stance at meetings with US private bankers has indicated a desire for a quick settlement in order to influence European creditors, who are traditionally more difficult for a Latin American country to deal with. The British in particular are expected to take a harder line at the Paris talks. The first session on 3 February probably will be followed by a two-week period during which officials of the creditor nations go home, digest the written material, and work out positions. Upon returning to Paris, the creditors will meet with Chile and the International Monetary Fund for further negotiations.

Prospects and Options

24. Even if it is successful in obtaining most of its renegotiation goals, Chile is likely to face very severe balance-of-payments problems during the next year or so. Under the best of foreseeable circumstances, Chilean imports in 1972 probably will not exceed \$1,150 million - a mere 2% more than last year's inadequate level (see Table 3). Under relatively unfavorable but still plausible conditions - and assuming no further drawdown on scant foreign exchange reserves - imports threaten to be as much as one-third below the 1971 level. Even an intermediate import level of something like \$950 million would leave supply seriously out of balance with demand and pose difficult adjustment problems for the Allende government.

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Table 2

Distribution of Debts Due During the Requested
Moratorium Period (1972-74), by Creditor

<u>Creditor</u>	<u>Percent</u>
United States	<u>43.9</u>
Export-Import Bank	20.5
US banks	10.8
Agency for International Development	3.9
Braden (Kennecott Corporation)	3.5
PL 480	0.9
Other private	4.3
International organizations	<u>14.5</u>
Inter-American Development Bank	6.7
International Monetary Fund	4.1
International Bank for Reconstruction and Development	3.0
International Financial Corporation	0.5
International Development Association	0.2
Rest of world	<u>41.6</u>
Italy	7.5
West Germany	6.0
France	5.6
Spain	3.8
United Kingdom	3.8
Belgium	3.5
Japan	2.3
Other	9.1
<i>Total</i>	<i>100.0</i>

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25. A marked increase in copper production and prices could raise import capacity above \$1,150 million, but such a rise is highly unlikely. By its own admission, the Chilean government is three years behind targeted copper production, and new technical and labor problems are arising faster than they are being solved. World copper prices may improve slightly in response to the reinvigoration of the US economy, but there is little chance that they will approach 1970 levels in the near future. Moreover, export availabilities for fruit and other agricultural items are apt to decline further, and there is little reason to expect exports of nontraditional industrial products to rise.

26. Chile's import capability in 1972 will depend most heavily on its ability to attract new foreign capital. Total net direct investment flows can be expected to be zero at best, and no new US credits of any kind are likely under foreseeable circumstances. On the other hand, it is likely that Allende will pay virtually nothing to US companies and as little as possible to the US government. As long as such a move does not frighten potential Japanese and West European creditors, he has little to lose. The decision to undertake foreign debt renegotiation, nevertheless, has subjected Chile's creditworthiness to closer worldwide scrutiny, and many creditors probably will decide that Chile's future ability -- or willingness -- to repay new loans is questionable. Western Europe and Japan will continue to provide some suppliers' credits in an effort to increase their shares of the Chilean import market, but these credits are unlikely to exceed \$50 million in 1972.

27. Soviet and East European aid will probably increase. With Cuba as an example to be avoided, however, both Allende and the Soviets want to limit the degree of Chilean dependence, and thus far virtually nothing has been drawn on the large project loans and suppliers' credits already provided. A Soviet decision to bail Chile out with more hard currency credits and food and petroleum supplies or an effective Chilean decision to shift to Communist area machinery and technology could significantly raise assistance flows in a relatively short period. On balance, however, it is doubtful that Communist assistance will add to Chile's import capacity by more than \$150 million this year.

28. Even if imports can be maintained at 1971 levels or somewhat higher, Chile will not be able to fulfill its requirements for both consumer and industrial goods. Shortfalls of either type will carry heavy political costs. The government's initial populist measures have reinforced the average Chilean's penchant for good living, and he will not willingly sacrifice his standard of living in the interest of a socialist revolution. Moreover, at a time when imports of almost all consumer goods are rising rapidly, a need for increased capital goods imports is also being felt. The political

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importance of maintaining output and employment -- largely dependent on imported machinery and raw materials -- is equal to that of maintaining living standards.

29. It is doubtful that Chile can obtain the foreign exchange to pursue either of these goals effectively; to do both would be impossible. To buy time in which to consolidate his political position, Allende will have to avoid increasingly apparent shortages and rationing of any kind in the months ahead. Thus he will probably opt to favor consumer demand at the expense of industrial output and growth. Clearly, such a policy will be merely a short-term measure that could exacerbate his difficulties in eventually coming to grips with Chile's fundamental economic problems.

30. Economic problems in themselves are not likely to bring about the government's downfall, but they will significantly increase Allende's political difficulties. In the face of increasing popular dissatisfaction and recent election losses, Allende's supporters already are torn between accommodation and radicalization -- extremes that Allende prefers to avoid. It remains to be seen if his political adroitness will be sufficient to permit him to steer a course between repression on the one hand and dilution of his "irreversible revolution" on the other. Allende realizes that the one issue that could possibly unite the Chilean people and lead to a voluntary acceptance of necessary belt-tightening is that of US "economic aggression." Using the United States as a scapegoat may well be the only good card in Allende's hand, and he will take advantage of any opportunity to play it.